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Attention:

Refer Reply To:  
CC:ITA:B01  
PLR-143307-06  
Date:  
May 01, 2007

Taxpayer	=
Date A	=
Date B	=
Date C	=
Date D	=
Target	=
Buyer	=
State X	=
Amount U	=
Amount V	=
Amount W	=
\$X	=
\$Z	=

This is in response to your letters dated September 13, 2006, and November 21, 2006. Specifically, you requested a ruling concerning the federal income tax consequences of a payment made by Taxpayer to terminate a gas sales contract.

Taxpayer, a natural gas marketer, was incorporated on Date A and organized under the laws of State X. In Taxpayer's role as a marketer, it provides services such as arranging for interstate and local transportation, balancing, and storage. As a marketer

that has no physical transportation facilities, Taxpayer relies on interstate pipelines and local distribution companies (LDC's) to provide transportation for the natural gas that it buys and sells.

Taxpayer provides a wide selection of pricing alternatives, among which are fixed-price or managed-price arrangements. A typical fixed-price arrangement usually provides for the sale of a fixed monthly quantity of natural gas at a stated price over an extended period of time, which can range from a few months up to two years or longer. A typical managed-price arrangement provides for a pricing structure composed of a mixture of fixed-price gas and open-market gas. Occasionally Taxpayer, or a customer, wishes to terminate either a fixed-price or managed-price arrangement and replace the arrangement with an open-market price arrangement. In such instances, the difference between the fixed-price or managed-price arrangement is either paid to the customer, or received from the customer, depending on whether the contract price is below or above market price.

On Date B Taxpayer made an election to be taxed as an S corporation. On the same date, Taxpayer purchased Target with Taxpayer as the surviving entity. The transaction was a taxable purchase, whereby Taxpayer paid \$X for the assets and liabilities of Target. It was a purchase of a trade or business pursuant to § 1060 of the Internal Revenue Code and § 1.1060-1(b)(1) of the Income Tax Regulations.

The assets and liabilities acquired by the Taxpayer included a group of trained employees, the goodwill that Target's sales representatives had engendered with Target's customers, and a large number of executory contracts, representing three groups. The first group were few in number and consisted of the Target's supply contracts with various natural gas providers and transportation companies. The second group of contracts (approximately Amount U), for sales to large-volume industrial and commercial customers, were quite lengthy and were based on either the Target's sales contract or the North American Energy Standards Board supply type of contract. The majority of the contracts (approximately Amount V) were for the sale of gas to small-volume purchasers under tariff provisions of representative LDC's such as Target.

Among these was a contract to sell natural gas to Buyer (Old Gas Sales Contract), which contained the following terms:

- 1) Taxpayer would supply up to Amount W dekatherms per day to Buyer. If Buyer required more than this amount Taxpayer would use best efforts to procure additional amounts, at market price.
- 2) The contract had a fixed, escalating price schedule through the life of the agreement.

- 3) Taxpayer was the exclusive provider of natural gas for Buyer. However, Buyer had no obligation to place an order for any given day, and did not have to make a minimum payment if no gas was ordered.
- 4) The natural gas would not be from designated sources.
- 5) Buyer could change the ordered amount within 24 hours of delivery without any penalty.
- 6) The term of the Old Gas Sales Contract was set to end on Date C, and then continue on a month-to-month basis thereafter. At this point it could be terminated by either party with 30 days notice.

The Old Gas Sales Contract was not part of a hedge and was not otherwise tied to a supply contract. The cost to acquire natural gas for sale under the Old Gas Sales Contract was not fixed, so there was no fixed gain or loss associated with the Old Gas Sales Contract at the date of the acquisition of Target. At various times up to and following the acquisition, the contract price was either higher or lower than the market value of gas; on the date of the acquisition the contract price was lower than market. The purchase price of Target's assets was not adjusted for gas market price fluctuations that occurred during the negotiation period. Taxpayer represents that the Old Gas Sales Contract was not a factor when arriving at the purchase price for the assets of Target. In accounting for the purchase for tax purposes, Taxpayer did not treat the Old Gas Sales Contract as either an asset or a liability.

On Date D, several years after the acquisition of Target, the market price of natural gas was well above the fixed escalating price schedule of the Old Gas Sales Contract. Taxpayer paid Buyer a \$Z termination fee to end the Old Gas Sales Contract. Taxpayer and Buyer then entered into the New Gas Sales Contract, which contained many of the same terms as the Old Gas Sales Contract. Specifically:

- 1) There was no fixed quantity for natural gas in the contract;
- 2) Taxpayer was not entitled to a minimum payment if Buyer did not order natural gas for a given day;
- 3) There was effectively no fixed delivery date since Buyer could cancel a nomination within 24 hours without penalty; and
- 4) Taxpayer had the exclusive right to supply all of the natural gas needs of Buyer.

In addition:

5) The fixed-price schedule was replaced with a price set to equal the first of the month's index as published in the Inside Federal Energy Regulatory Commission's Market Report for the specific pipeline that Taxpayer used to make delivery to Buyer; and

6) The new contract contained an early termination fee to be imposed on Buyer.

### RULINGS REQUESTED

1) The termination fee does not have to be capitalized as a cost of the assets acquired in the prior business acquisition pursuant to § 263(a) of the Internal Revenue Code or the corresponding regulations;

2) The termination fee does not have to be capitalized as an amount paid to create a separate and distinct asset, or to create, improve, or increase the value of a financial interest, under § 263(a) of the Code and § 1.263(a)-4 of the Income Tax Regulations.

### LAW & ANALYSIS

#### Issue 1

Section 162(a) provides generally that there is allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a)(1) provides generally that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments. See §§ 1.263(a)-1(a)(1); see also §§ 1.263(a)-2(a), (h); 1.263(a)-4(c)(1) (costs of acquiring tangible and intangible assets).

Section 1060 provides for the allocation of consideration relating to the acquisition of assets constituting a trade or business. Section 1.1060-1(c)(2) provides in part that for purposes of determining the purchaser's basis in each of the assets purchased in an applicable asset acquisition, the purchaser allocates consideration by using the residual method under § 1.338-6 and § 1.338-7. The residual method, as described in § 1.338-6 and § 1.338-7, requires the purchaser to allocate the overall purchase price for both tangible and intangible assets to each of several asset classes in sequence.

Section 1060 and the § 338 regulations do not tell what the aggregate amount-realized figure is or the aggregate basis figure. They merely tell the seller and purchaser how to allocate those aggregate figures among individual assets transferred in transactions to which § 1060 applies. The aggregate figures, including any amounts attributable to the assumption of liabilities, are determined under other provisions of the Code. See, e.g., § 1.338-7(a), -7(e), *Ex. (1)* (example of allocation of consideration attributable to

assumed liabilities that, following "general tax law principles," are taken into account subsequent to the asset acquisition).

Section 461(a) provides generally that the amount of any deduction shall be taken for the taxable year which is the proper year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) provides generally that under the accrual method of accounting, a liability is incurred and generally taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Generally, under § 263(a) and § 1012, the assumption of a liability of a preceding owner of property by the person acquiring the property, whether or not the liability was fixed or contingent at the time the property was acquired, does not give rise to a deduction when the liability is paid. Instead, such a liability is capitalized by the purchaser and added to the basis of the acquired property, either at the time of acquisition or later, depending on when it is properly taken into account under § 461. See Illinois Tool Works v. Commissioner, 117 T.C. 39, aff'd, 355 F.3d 997 (7th Cir. 2004); Commissioner v. Oxford Paper Co., 194 F.2d (2d Cir. 1952); Rev. Rul. 55-675, 1955-2 C.B. 567; Rev. Rul. 76-520, 1976-2 C.B. 42. Cf. Crane v. Commissioner, 331 U.S. 1 (1947).

The Service and the courts have used a number of related factors to identify a contingent liability the assumption of which should be viewed as part of the consideration for an asset, including: 1) Whether the liability related to the seller's or the purchaser's operation of the business; 2) Whether the liability arose out of pre- or post-acquisition events; 3) Whether the purchaser was aware of the liability; 4) Whether the liability was contemplated when negotiating the purchase price, 5) Whether the purchaser expressly assumed the liability; and 6) Whether the purchaser could have avoided the liability. See, e.g., Rev. Rul. 55-675; Illinois Tool Works; David R. Webb Co. v. Commissioner, 708 F.2d 1254, 1257 (7th Cir. 1983), affg. 77 T.C. 1134 (1981); Pacific Transport Co. v. Commissioner, 483 F.2d 209 (9th Cir. 1973), cert. denied, 415 U.S. 948 (1974); United States v. Smith, 418 F.2d 589 (5th Cir. 1969); Albany Car Wheel Co. v. Commissioner, 333 F.2d 653 (2d Cir. 1964), aff'g 40 T.C. 831 (1963); United States v. Minneapolis & St. Louis Ry., 260 F.2d 663 (8th Cir. 1958); M. Buten & Sons, Inc. v. Commissioner, T.C. Memo 1972-44.

At the time of the acquisition, Taxpayer was aware of all the contracts it was acquiring, including the Old Gas Sales Contract, and expressly assumed the benefits and burdens of the Old Gas Sales Contract. However, the contract was executory: although it was probable that Buyer would order gas in the future, any liability on the part of Target (and, subsequently, Taxpayer) was contingent on Buyer's nominating an amount of gas and incurring an obligation to pay for it. Cf. Rev. Rul. 80-182, 1980-2 C.B. 167; Rev. Rul. 2007-3, 2007-4 I.R.B. 1 (executory liabilities not fixed for purposes of the all-events

test in § 461). Like most of the other contracts Taxpayer acquired, the value of Taxpayer's Old Gas Sales Contract fluctuated with the market price of natural gas, and could be positive or negative depending on price movements. As represented by Taxpayer, the value of Target's contracts, including the Old Gas Sales Contract, was not a factor in negotiating or setting the purchase price for Target. Rather, the purchase price primarily reflected the value of Target's personnel, customer relations, and goodwill. At the time of the acquisition Taxpayer could not predict what future market conditions would be for the natural gas market, and it was not until Date D, several years after the acquisition, that Taxpayer approached Buyer to terminate the Old Gas Sales contract. The Old Gas Sales Contract became disadvantageous due to conditions that were attributable to the period during which Taxpayer had the business relationship with the Buyer, as part of the acquired business. The preceding factors indicate that the Old Gas Sales Contract was not a contingent liability the assumption of which was part of the purchase price of Target's business.

## Issue 2

Section 1.263(a)-4(b)(1)(iii) provides that a taxpayer must capitalize an amount paid to create or enhance a separate and distinct intangible asset, but § 1.263(a)-4(b)(4)(ii) provides that amounts paid to another party to create, originate, enter into, renew, renegotiate, or facilitate an agreement with that party are not treated as amounts that create or facilitate a separate and distinct intangible asset. Further, amounts paid to another party to terminate an agreement with the party are not treated as amounts that create a separate and distinct intangible asset.

Accordingly, the termination payment did not create a separate and distinct intangible asset.

Section 1.263(a)-4(b)(1)(iii) provides that a taxpayer must capitalize an amount paid to create an intangible described in § 1.263(a)-4(d), and § 1.263(a)-4(d)(2) generally provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of certain financial interests, including 1) a letter of credit; 2) a credit card agreement; 3) a notional principal contract; 4) a foreign-currency contract; 5) a futures contract; 6) a forward contract; 7) an option; and 8) any other financial derivative.

The New Gas Sales Contract was not a "financial instrument" as defined in § 1.263(a)-4(d)(2).

First, it was not a notional principal contract. A notional principal is defined in § 1.446-3(c) as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal in exchange for specified consideration or a promise to pay similar amounts. The New Gas Sales Contract did not involve the exchange of payments based on a notional principal amount.

Second, it was not a forward or futures contract. Section 1.263(a)-4(d)(2)(i)(6) provides that a forward contract includes an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property). Section 1.263(a)-4(d)(2)(vi), *Example (4)*, provides that a natural gas producer that pays \$1,000,000 to enter into a five-year "take or pay" gas sales contract, under which the purchaser is liable to pay for a specified minimum of gas whether or not the purchaser takes the gas, must capitalize the payment. The New Gas Sales Contract had no fixed price or quantity of gas, and did not require the purchaser to take, or pay for, a minimum quantity of gas.

Third, it was not an option contract. Section 1.263(a)-4(d)(2)(i)(6) provides that an option contract includes an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property). The New Gas Sales Contract did not provide Taxpayer with the right (but not the obligation) to provide or acquire property.

For similar reasons, the New Gas Sales Contract was not an "other financial derivative" under § 1.263(a)-4(d)(2)(i)(8). Given that it provided for sales at market price and did not have a fixed amount or minimum, it primarily reflected the ongoing business relationship between Taxpayer and Buyer, not a contract with independent financial significance.

## RULINGS

- 1) The termination fee does not have to be capitalized as a cost of the assets acquired in the prior business acquisition pursuant to § 263(a);
- 2) The termination fee does not have to be capitalized as an amount paid to create a separate or distinct asset, or to create, improve, or increase the value of a financial interest, under § 263(a) and § 1.263(a)-4.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

Andrew M. Irving  
Senior Counsel, Branch 1  
(Income Tax & Accounting)